Risk Hedging Protection Act

Need for Legislation

In 2012, the Commodity Futures Trading Commission (CFTC) proposed a wide-ranging “customer protection” rule that included a provision commonly referred to as the “residual interest” rule. While stakeholders support increased customer protections, the residual interest provision has raised concerns from end users of the futures market, including farmers and ranchers, grain merchants, and futures brokers. The CFTC modified the residual interest provision when the rule was finalized in 2013; however, the changes did not fully address the concerns of stakeholders.

Problem Facing Futures Customers Because of the New Rule

The CFTC residual interest rule will eventually require futures customers to deposit the cash required to fully cover the margin of their futures contracts by the morning of the day following a trade. Unfortunately, many customers and end users will not be able to transfer funds to their Futures Commission Merchant (FCM) in time to meet this requirement, which will likely lead to FCM’s requiring the prefunding of margin accounts. The end result may drive some end users out of futures markets due to increased costs, leaving them without a market-based tool to manage their risk. Furthermore, the prefunding of margins will restrict capital that could otherwise be used to hire, make capital improvements, and other critical investments.

Prefunding margin accounts will require customers to send significantly more money to their FCM in advance of market moves that may never occur. Customers would be required to pay their initial margin as well as a maintenance margin that assumes price swings in the market. In some circumstances, customers may be required to prefund twice the margin to maintain their accounts. Additionally, in the event of an FCM insolvency similar to MF Global, the CFTC residual interest rule could mean twice as much customer funds at risk.

The residual interest rule will also put additional financial pressure on the smaller to mid-sized FCMs that serve agriculture. These relatively smaller FCMs do not have the large balance sheets that other FCMs may have at their disposal. A likely outcome will be consolidation among FCMs that will result in increased concentration in the FCM sector and greater concentration of risk.

How to Fix the Problem Created by the Residual Interest Rule

The CFTC rule aims to increase customer protection by narrowing the window that FCM’s have to receive necessary margins. By requiring a more timely deposit of margin, oversight will be more effective at recognizing trouble in firms when they occur. Additionally, the proposal would give bad faith actors like MF Global less time to steal customer’s funds without getting noticed. However, the CFTC proposal, if fully implemented, may do more harm than good by increasing the costs of business for the farmers and ranchers that the rule seeks to protect.

The Roberts-Heitkamp bill would strengthen customer protections in a way that does not needlessly increase the costs to end users. The legislation requires futures customers to deliver sufficient funds to their FCM to cover their margin requirement by the end of business on the day following a trade, rather than the morning following a trade. Roberts-Heitkamp tightens the time frame futures customers had prior to the residual interest rule (3 days), but will prevent prefunding of margins and its unintended adverse consequences.